German inflation increases in May

German headline inflation increased in May and illustrates inflation stickiness in the entire eurozone

The just-released flash estimate of German inflation in May illustrates the stickiness of inflation in the entire eurozone. Headline inflation came in at 2.4% year-on-year, up from the 2.2% YoY in April but still below the 2.5% YoY recorded in February. The European inflation measure came in at 2.8% YoY from 2.4% in April. The increase in headline inflation was mainly triggered by higher services inflation as a result of a reversed base effect from last year's introduction of cheap public transportation. Most other components saw mainly stable inflation rates.

Remember that the main differences between the national and the European inflation measures are varying weights for individual consumer goods and the fact that the national measure includes prices for gambling and owner-occupied housing.

Inflation remains sticky

Today's German inflation data not only illustrates the ongoing impact of base effects and earlier government measures on present inflation but also stresses how sticky inflation remains. That stickiness looks set to continue as favourable energy base effects are petering out while, at the same time, the economy is gaining traction and wages are increasing.

Earlier today, the statistical office reported the highest increase in real wages since 2008, up by

3.8% year-on-year in the first quarter. The stickiness of inflation is also reflected by companies' selling price expectations, which in manufacturing have stabilised slightly below historical averages and, in the services sector, clearly above. As a result, we continue seeing inflation hovering within the broader range of between 2% and 3% rather than returning on a straight line to 2%.

ECB will cut in June but what then?

Today's increase in German headline inflation is a good reminder of how difficult the last mile of bringing inflation sustainably back to 2% will be for the European Central Bank. Still, with an entire choir of ECB Governing Council members once again singing about rate cuts, anything other than a cut of 25bp next week would be a major surprise, not to mention a severe reputational loss for the central bank.

The debate at the ECB seems almost to have shifted further to what will happen after the June cut. In the past, rate-cut cycles were mainly triggered by either a recession or a crisis. Fortunately, none of these is currently threatening the eurozone economy. Consequently, there is no pressing need for the ECB to cut rates or to engage in a longer series of rate cuts. Instead, the ECB will cut rates not so much because it has to but simply because it can. Or, as Chief Economist Philip Lane put it, the ECB will *"remove the top level of restriction*".

In the context of the debate on what will happen after the June meeting, today's German data also shows that the risk of reflation is real, at least for a central bank defining price stability with an inflation rate of 2.0%. This risk of reflation together with an eurozone economy gradually recovering limits the ECB's room for manouvre beyond the June meeting.

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